



Streamlined Sales Tax: An Update For Small Businesses

By: Phil Harper and **Dwayne N. McSwain**

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STREAMLINED SALES TAX: AN UPDATE FOR SMALL BUSINESSES

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ABSTRACT

Small businesses and local governments are concerned about a proposal that will result in a massive change for sales tax collections. The Streamlined Sales and Use Tax proposal advocates use of destination sourcing for remote tax collections. The tax revenue will enhance the coffers of the states where the product is delivered, rather than where the sale takes place or where the buyer resides.

The primary concern for state and local governments is lost tax revenue from Internet sales. Although many small business owners believe taxing Internet sales will level the playing field for all businesses, most small businesses do not have the necessary resources to implement a complex sales tax collection system. Any law for collecting Internet sales and use taxes, without some type of exception for small businesses, could have a dire economic impact on many small businesses. The authors discuss the genesis of the initiative and provide a current update of the initiative and its complications. However, the Streamlined Sales and Use Tax proposal is complex and dynamic. Small business owners should continue to monitor the proposal and its potential impact on their business.

INTRODUCTION

Small businesses and local governments are watching, with much anticipation, proposed procedural changes in collecting state sales tax. Struggling with budget demands, states throughout the country hope they have found a remedy—collecting sales tax on all Internet sales, many of which are currently exempt from collection. With Internet sales skyrocketing over the past decade (Collins, 2002), e-commerce is the driving factor behind a multistate initiative to track both intrastate and interstate sales. Using a cloak of “equitability,” the Streamlined Sales Tax Governing Board, formerly known as the Streamlined Sales Tax Project (SSTP), provides a forum for states and some businesses interested in reducing the burden of collecting and administering state and local taxes. Current law requires retailers to collect sales tax only in states where they have a physical presence (nexus). However, a movement has been underway for several years to change these laws, and a coalition of states is pushing for federal legislation to regulate Internet sales tax collection.

The coalition was officially formed in March of 2000, when 39 states and the District of Columbia gave tacit approval to a group initiative aimed at collection of sales and use taxes across state lines. If e-commerce transactions were the only activities monitored by the coalition, this would be a more straightforward matter and it would seem to be an easy solution for bolstering state coffers. However, other issues make this matter more complex. The initiative appears to be slowly gaining recognition but stops short of the vexing issues associated with the cost of implementation: destination sourcing and redistribution of wealth.

U.S. SUPREME COURT FINDINGS

In a 1992 case involving mail-order tax collection (*Quill Corp v. North Dakota*, 1992), the Supreme Court suggested remote tax collections would place an undue burden on interstate commerce and that if the states wanted "remote sellers" to collect and remit taxes, the states would have to develop a simpler, more uniform system. The interstate commerce clause of the U.S. Constitution requires that there be a sufficient connection (substantial nexus) between the taxing authority and the person burdened by the tax. For purposes of interstate commerce, a nexus requires that a seller have a physical presence in a state before the seller is obligated to collect a sales tax for that state. In an earlier case (*National Bellas Hess v. the Department of Revenue of the State of Illinois*, 1967), the U.S. Supreme Court sided with an office supplies cataloger that sufficient nexus did not exist to impose obligation for collection of a state sales tax. The high court in both cases noted the U.S. Congress has the ultimate power to resolve the tax collection issue.

COMPLEXITIES

Small Business Concerns

Traditional retailers without an online presence argue that e-commerce vendors have an unfair advantage in bypassing the sales tax system, which was devised prior to the advent of e-commerce. Many small business owners feel that collecting sales tax on Internet transactions would level the playing field for all businesses. Because of the penalties associated with noncompliance, it might behoove e-tailers to properly collect and remit sales tax to taxing jurisdictions. Some argue, however, the equivalent of a sales tax is already in place. A "use tax" is the equivalent of a sales tax, but residents who do not pay the sales tax are responsible for the self-reporting of this tax obligation.

Brick and mortar stores, such as Wal-Mart, already have the accountants and software systems needed to comply with sales tax issues in most states. Small businesses are not always as fortunate, and many lack the necessary resources to implement such a complex system. Logistically, the Governing Board's plan is that businesses have three options for collecting sales tax on Internet sales: (1) turn the tax administrative function over to a certified service provider that is compensated by the states (at no charge to the merchant), (2) use a certified automated system to perform the function in-house, or (3) build a technology solution meeting the approval of the collective states. Although several proprietary systems are available to facilitate the collection and transmittal of sales taxes, the price of these systems may not be feasible for many small businesses. Small firms, heavily dependent on the owner's ability to hold down costs, are beginning to feel the pressure of compliance.

Implementation

Many issues remain unresolved. At the core of the Streamlined Tax proposal is the issue of destination sourcing. Implicit in the use of destination sourcing is that the applicable sales tax is ultimately collected in the jurisdiction in which the goods are delivered. Neither the location of the seller nor the address of the credit card holder is a determining factor. This is a major paradigm shift in the tax collection process, even when excluding the consideration of e-

commerce activity. Although many states have passed legislation enabling the consideration of such a project, most are either letting that legislation reach its sunset date or are delaying implementation. At the state level, the destination sourcing issue involves consideration of not only state sales tax redistribution, but also redistribution of county and city sales taxes. Some of the complex issues facing implementation of a Streamlined Sales Tax are:

- Establishing uniform definitions of property classes
- Requiring destination-based sourcing on all sales
- Creating, maintaining, and updating a central electronic database
- Standardizing exemptions and auditing procedures
- Eliminating caps and thresholds
- Simplifying tax remittances and tax returns
- Addressing the issue of sales tax holidays
- Establishing a uniform state and local tax base
- Allowing only one state rate and one local rate per jurisdiction
- Administrating all sales and use taxes, even the local share
- Defining digital equivalents of tangible personal property
- Establishing procedures to distinguish exempt property in a bundled product
- Addressing consumer privacy issues

Sourcing Issue

Destination sourcing is proving to be one of the most controversial issues facing Streamlined Sales Tax because of its application to intrastate sales. Small retailers delivering goods to other intrastate localities vehemently object to using destination sourcing. They argue that destination sourcing would place an insurmountable burden on them to collect taxes at various rates for jurisdictions statewide. Such a system would require small firms to track sales by state, by in-state jurisdiction, and possibly by item. This matter is further complicated by various remittance requirements of the appropriate taxing jurisdictions.

Traditionally, most states have assessed in-state sales tax on an origin basis. Thus, sales taxes are collected and remitted from the point of sale. Basically, small businesses want a simple, direct, low-cost way to collect and remit taxes. Small businesses individually voicing concerns may have limited impact, but their concerns are amplified by local government agencies. Tax breaks, used to woo large business operations, will be an even greater issue when taxes formerly benefiting business hubs are redirected to population centers.

When enacting other Streamlined Sales Tax conformity provisions, the states of Texas and Washington did not adopt destination-based sourcing. All sales-tax states, except Colorado, are addressing the initiative in some form. Changing to a destination-based system is a potential problem in several other states. In *Quill Corp v. North Dakota* (1992), the Supreme Court advocated a simpler system and probably did not foresee a two-track system—an origin-based system for in-state sellers and a destination-based system for out-of-state sellers. Such a double standard might be deemed discriminatory and held to violate the Commerce Clause of the U. S. Constitution. Even if the collection of taxes can be managed, an economic transfer of wealth issue arises. A dual system would certainly turn out to be a Pandora's box for most small businesses.

Other Obstacles

Though destination sourcing has been the most contentious issue of the Streamlined Sales Tax provision, many others exist. Safe harbors for over-collection; amnesty; failure to adopt all necessary definitions in medical areas; missing statutory authorization for vendor compensation; misinterpretation of common definitions of food items, school supplies, or art supplies—these are all issues to be addressed before a smooth and seamless transition can be made.

Consider that 45 states have sales and use taxes with multiple city and local taxing jurisdictions. Conflicting rules as to what items or services are taxable add to the fray. Different rules for different people at both the state and local levels increase the confusion. In most states, food and drug items are taxed when purchased in a restaurant, but in many states these items are taxed at a reduced rate or not taxed at all in a grocery store. Having to wade through definitions of what is or is not a food or drug item will certainly be a cumbersome exercise. Is a cookie or a candy bar considered food or candy? Are art supplies for personal or educational purposes? Are medical supplies and medical equipment subject to equal taxation? In Tennessee, dog bathing is subject to the sales tax, but dog grooming is exempt (Tennessee Department of Revenue, 2007). Dog bathing is considered the use of a consumable product/service (shampoo is not reusable), while dog grooming is considered the use of a nonconsumable product/service (shears and clippers are reusable). The logistics for keeping up with such a sales tax system are overwhelming for many small businesses.

The project has yet to address global business transactions. With the plethora of international taxes—for example, the Value Added Tax (VAT)—how does a small business implement collection of a destination tax? The issue is also political because it is a states' rights issue. Are states willing to give up their inherent right to determine the rate of tax they impose? Undercutting their sovereignty, states participating in the project are rapidly becoming aware of the concessions that must be made. In reporting to the Internal Revenue Service, for those states in which no state income tax is imposed, the federal government currently allows a deduction for sales tax paid. Will this be complicated by the initiative?

PROJECT STATUS

Plan of Implementation

When the Streamlined Sales Tax Project was initiated, states were categorized as either participatory or nonparticipatory. Achieving participatory status is a two-step legislative process. First, a state must adopt legislation enabling it to enter into an agreement with other states to simplify and modernize sales and use tax administration. This legislation enables the state to formally participate in the initiative but does not require changes to the state's sales and use tax law.

The second legislative component is to amend the state's sales and use tax laws, by adopting the Streamlined Sales and Use Tax Agreement, to achieve conformity with the simplifications and uniformity required of the participant states (Streamlined Sales Tax Governing Board, 2007b). The state is then issued a certificate of compliance with the interstate agreement. A state can be sanctioned or expelled by other participating states if found to be out of compliance with the agreement. Under this compact, the initiative would become effective when

at least 10 states representing 20% of the total population were in compliance with the agreement. This hurdle was surpassed in July 2005, when the governing board was established (Streamlined Sales Tax Governing Board, 2007c).

Broader Membership Categories

The two original membership categories (participatory and nonparticipatory) have been broadened to reflect various levels of commitment to the plan and now include these categories: "full," "associate," "advisory," or "participating." Because the initiative in each state involves commitment at various levels of government (depending on jurisdictional law), it should be noted that membership status is neither indicative of the level of Internet sales tax collection nor the degree of implementation of a sales tax collection process. Rather, the four categories imply the level of legislative interest.

A full member state is in compliance with the Streamlined Sales and Use Tax Agreement through its laws, rules, regulations, and policies. Associate membership status allows for two positions: either (1) a state is in compliance with the Streamlined Sales and Use Tax Agreement except its laws, rules, and regulations are not scheduled to be in effect on or before January 1, 2008, or (2) the state has substantial compliance with the terms of the agreement as a whole, but not necessarily each provision, and plans to achieve full compliance by January 1, 2008.

States holding advisory status have indicated an interest in complying with the project but have no vote on the Governing Board. Any state with a sales tax can have a delegate on the state and local advisory committee. Participation status indicates some level of interest in the initiative. Texas, California, and Nevada have complex sales tax structures at the local level, thus they are still at the discussion stage. Colorado is the only state with a state sales tax not indicating some level of initial recognition. The status of each state is depicted in Figure 1.

The Streamlined Sales Tax Project website (www.streamlinedsalestax.org) provides information regarding specific states in total compliance, in partial compliance, and in the legislative process. As jurisdictional information and status is constantly in a state of flux, interested individuals should access the "State Legislation Status" component of the website toolbar.

Puerto Rico, as a U.S. protectorate, has recently enacted a sales tax and is included in the population pool as an associate member. Currently, 44 states indirectly or directly support the initiative and have either enacted or are working toward legislation to harmonize their regulations. Only about a third of the states are full members, working on collecting Internet sales tax. Alaska, Delaware, Montana, New Hampshire, and Oregon do not have state sales taxes (Streamlined Sales Tax Governing Board, 2007a).

Although some states have full-member or associate-member status, local governments, small business interests, and other affected groups are calling for further study of the initiative. Kansas (Kansas Legislature, 2006) and Ohio have adopted destination-based sourcing but are delaying the effective dates of enactment. The state of Iowa has repealed sourcing rules needed to comply with the agreement (National Conference of State Legislatures, 2006). In Tennessee, the governor has asked the legislature to delay the implementation of Streamlined Sales Tax for at least two years (Wissner, 2007). Small business owners may visit the Federation of Tax Administrators website (www.taxadmin.org) to determine current state legislative action related to their specific business concerns.

Membership Status:

- No Sales Tax
- Full
- Associate
- Advisory-Compliance Legislation Introduced
- Participating
- Nonparticipatory

Renewed Interest at the Federal Level

Legislation was introduced in the 109th Congress—the *Sales Tax Fairness and Simplification Act* (S. 2152) by Republican Senator Mike Enzi of Wyoming and the *Streamlined Sales Tax Simplification Act* (S. 2153) by Democrat Senator Byron Dorgan—to give those states in compliance with the agreement the authority to require out-of-state sellers to collect their sales and use taxes. A slight difference between the two bills involves an exception for small business. Under Senator Enzi's bill, a state can require immediate collection from businesses other than those realizing less than \$5 million annual gross remote, taxable sales. However, Senator Dorgan's bill does not define small business and requires the Small Business Administration and Congress to establish a definition of small sellers within 180 days of enactment of the proposed legislation. Under Senator Dorgan's bill, member states would not be allowed to collect any sales and use taxes with respect to remote sales, unless a small business exception for remote sales is approved.

Legislation similar to Senator Enzi's bill has also been introduced in the 110th Congress—the *Sales Tax Fairness and Simplification Act* (H.R. 3396) by Democratic Representatives William Delahunt, Spencer Bachus, and Ray LaHood. Although it is not surprising that similar bills would be introduced in both the House and Senate, it is interesting that the issue of sales and use tax has drawn bipartisan support. This across-the-aisle support may be indicative of the magnitude of the problem at hand. With projected online retail sales reaching \$174.5 billion in 2007 (\$259.1 billion, including travel), it is easy to see why so many diverse stakeholders are interested in Internet taxes (Forrester Research, 2007).

Given the extraordinary growth of Internet sales over the last decade, proponents of the initiative are sure to keep their congressmen abreast of all issues that might be remotely related to the sales tax issue. Although opponents are sure to do likewise, their efforts appear to be less organized. All small business owners, whether initially "for" or "against" the initiative, should educate themselves about the Streamlined Sales and Use Tax proposal and the potential impact that such a law might have on their business. Most, if not all, states have a website dedicated to Sales and Use Tax and provide answers to frequently asked questions about the Streamlined Sales Tax initiative. Small business owners should be proactive and should contact their congressmen with any concerns prior to the passage of this or any other similar proposal.

CONCLUSION

As e-commerce, especially Internet sales, continues to thrive, many states are pushing for federal legislation to regulate the collection of sales and use taxes on Internet sales. In March of 2000, a coalition of 39 states was formed and the Streamlined Sales Tax Project was created. Now recognized as the Streamlined Sales Tax Governing Board, the coalition has grown to 44 states and the project has evolved, but the issue has not been resolved. The U.S. Supreme Court has ruled on a couple of cases of remote tax collections and suggested that this is a matter for the U.S. Congress to settle, because it involves interstate commerce and constitutional requirements for nexus between the taxpayer and the taxing authority.

Due to the many complexities involved, the Streamlined Sales and Use Tax proposal is still in the incubator stage. The Governing Board continues to pursue new avenues of assistance for those states interested in attaining full-member status. Advocates are both vocal and aggressive in touting the initiative as a means of reaching tax neutrality. Although many small business owners feel that taxing Internet sales would level the playing field for all businesses, many opponents view the initiative as a stealth tax and regulatory burden on every business in America. The initiative, in its current state, provokes contention between small and large retailers. Perhaps this issue would be more readily resolved if the concept of destination sourcing could be independently distinguished for intrastate sales and for interstate sales.

Although the Internet allows businesses to reach many new customers, it has been a double-edged sword for many small business owners. On one hand, more customers often mean more sales. On the other hand, there is a lot more competition. Businesses of all sizes are more frequently competing for the same Internet customers, and more often than not the competitive advantage goes to the larger firms. Moreover, small businesses must collect sales tax on in-store sales, while many e-tailers are able to avoid collecting any sales tax.

While many believe the Streamlined Sales and Use Tax initiative will be a boon for small business owners, the initiative may also place some new burdens on those businesses, particularly relating to costs. Many small businesses do not have the resources or the funds

needed to implement complex software systems needed for collecting sales tax on Internet sales. Also, destination sourcing would force small businesses to track sales by state, by in-state jurisdiction, and possibly by item in order to collect taxes at the various rates for jurisdictions statewide. These small retailers may have to increase their staff size, thereby increasing costs, just to ensure that the proper amount of tax is being collected and remitted.

Although small business exceptions to the proposed Internet sales tax legislation have been introduced, none have been finalized. Therefore, small business owners should be proactive and should contact their congressmen with any concerns they have prior to the passage of such legislation. Small business owners may also be interested in voicing their concerns to the Streamlined Sales Tax Governing Board, which conducts teleconference meetings open to the public (www.streamlinedsalestax.org).

State and local governments' quest for increased tax revenue seems to overshadow concerns about enactment. The political reality is that these differences will have to be resolved for the initiative to be successful. Resolution may be accomplished only by an Act of Congress.

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